Fair value reporting advantages and disadvantages

Environment, Air

Discuss the pros and cons of fair value reporting for investors? Why has this trend emerged, and how does asset value volatility seen during and since the Global Financial Crisis effect your views on this?

There have been many debates in previous decades amongst the investors, users of the financial statements, on whether fair value accounting is worth being used. According to IFRS 13, fair value is “ the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date” (ACCA, 2016). Usage of fair value has advantages, however, it has disadvantages as well. This essay will discuss how fair value is more advantageous than disadvantageous and how it is carried out. It will also examine how fair value led Lehman Brothers, an American investment bank, into bankruptcy during the global financial crisis and why the trend of fair value has emerged in the recent decades.

As historical cost loses relevance with the passing of time, it is more appropriate to use fair value reporting as it considers current market prices and conditions. This provides investors with the most relevant estimates of the value of business (Gjorgieva-Trajkovska et al., 2016), and timely information which is important for making investing decisions (McEnally, 2007). Penman (2007) states that fair value accounting reports assets and liabilities through an economist’s view and therefore reports economic income – the change in fair value of net assets on the balance sheet. This is of interest to investors as they can make predictions of future earnings based on current information (Marra, 2016). On the other hand, Sundgren (2013) claims that there will also be fluctuations in fair values, leading to

uncertainty of future inflows. Although this poses a disadvantage towards certain stakeholders, it is helpful to investors as high fluctuations could indicate high risk, which may reward them with high returns.

Another advantage of fair value reporting is the reliability and transparency of the method. More transparency means that the investors are able to get an insight into the real value of the company. This allows investors to make more informed decisions that will benefit the business (Bigelow, n. d.). Fair value reporting is reliable as it " can be checked in hindsight from available information about current and past market prices" (Betakova et al., 2014). This is beneficial for the investors as it means that they can be confident that their decisions are correct and that the finances of the business will not suddenly change.

Bubble prices can be an issue for investors as it may mislead them into making poor investing decisions. There is plenty of empirical evidence to show that bubble prices exist (Ryan, 2008). These price bubbles, according to Penman (2007), are introduced into financial statements through the usage of fair value accounting. He goes on to say that this causes bubble gains to reflect on the income statement, and these may, falsely, show the company as being healthy which could lull investors into a false sense of security. These bubbles also result in the investor receiving ineffective financial statements which will impair their decision making. An example of this would be where investors pay prices that far exceed their own valuation (Scheinkman and Xiong, 2003). This would make it tough for investors to earn a reasonable return on their investments. However, the research fails to

consider the difficulties locating price bubbles or how investors can prevent themselves from being misled. It also fails to consider that bubble prices show the current trading price, albeit inflated, and therefore show the true value of the investment according to current prices.

When there is illiquidity in a market, fair value is called mark to model accounting. Ball (2006) explains that when this occurs, market prices are not accurate as firms try to find an approximate value for the assets. He continues by stating that this can let managers easily manipulate values according to their own preferences – affecting the reliability of financial statements. Betakova et al. (2014), argues that measurement procedures of fair value create loopholes and this means that prices can be written as vastly different from what they really are, which again allows manipulation.

The fair value of assets and liabilities is derived from the 3 level hierarchy of inputs. According to IFRS 13, the highest priority is given to level 1 inputs – the quoted price of assets and liabilities that are traded in the active market. Laux et al. (2010) state that assets or liabilities should be " marked to market", which means that the quoted price has to be used to determine its fair value as it is the best approximation of how much an asset would be sold for (Magnan, 2009). IFRS also emphasises that the price to be used has to be those of an orderly transaction to ensure that it is not a forced transaction in order to maintain its representability. An example of level 1 valuation would be listed stocks or bonds. In cases where an asset does not have an active market, level 2 fair value measurement should be used. This is when the valuation inputs are directly or indirectly observable but do not fall under

Level 1 (Magnan, 2009). Level 2 inputs, the net replacement cost, include quoted prices for similar assets or liabilities in active or non-active markets, and other relevant market data like the yield curves (Sundgren, 2013). For example, Petrobras issued a bond which is not traded. However, if there is an active market for a Valero Energy bond that is similar, the price of the Valero Energy bond can be used as level 2 input to value the Petrobras bond. Finally, the least priority is given to level 3 inputs, which are unobservable inputs. It is the least accurate as it is based on model assumptions. An example of level 3 measurement is when there is no observable input to value the Petrobras bond, then the value of the bond can be estimated by discounting its future cash flows. As a result, the reliability is reduced due to the subjectivity of the discount rate. Fair value is argued to be more appropriate, compared to historical cost, when level 1 valuation is used as it only allows minimal manipulation. However, during 2008, many companies overvalued their assets by using the level 3 measurement, contributing to the global financial crisis. Furthermore, there is an advantage in valuing certain assets using historical cost over fair value, like property, plant and equipment. This is because historical cost results in a more consistent calculation of depreciation. Moreover, under fair value, assets would need to be revalued frequently due to changing market conditions and this would impose additional costs to the organisation (Christensen and Nikolaev, 2013).

Fair value was a dominant force in the financial crisis and ‘ exacerbated its severity’ (Cai-xia and Chi, 2010). Huizinga and Laeven (2009) note that fair value is ‘ procyclical’ and therefore intensifies the phases in the economic

cycle. They expressed that banks were materially impacted due to the contrast between ‘ market and book values’. Lehman Brothers was an American investment bank, founded in 1850, and was the fourth-largest investment bank in the United States. Its bankruptcy in 2008 was a prominent event in magnifying the repercussion of the financial crisis (Acharya and Richardson, 2009). One of the pivotal reasons for this collapse was due to the high leveraging (Lehner, 2016). Lehman disguised this from stakeholders by utilising fair value accounting and creative accountancy. The incentive behind such manipulations would be the benefit pressurised managers derive by camouflaging vulnerabilities in the organisation. This is proved by the movement of the leveraging ratio from 23. 7: 1 in 2003 to 30. 7: 1 in 2007 (SEC Info, 2007) which signifies a high level of risk to investors. In addition, Azadinamin (2012) mentions that accounting standards, due to their defects, enable management to misrepresent financial information for momentary monetary rewards. He states further that Lehman window dressed the financial statements, using fair value, to present ‘ healthy looking balance sheets’ which assisted in concealing a major complication – negative cash flows. Magnan (2009) states that ‘ As of November 30, 2007, 75. 1% of assets measured at fair value were measured according to level 2 or level 3 inputs’. This indicates that Lehman generally did not use the more reliable level 1 values. In addition, the proportion of assets valued using level 2 or 3 “ increased to 81. 7% the following year”. This shows the speed at which reliability in the accounting method was reduced. It is backed up by the empirical evidence provided by Magnan which shows that the movement from level 1 to levels 2 and 3 was done intentionally so that they were able

to report assets too highly and hide losses. He goes on to explain that fair value provides beneficial information to investors when ' assets trade in deep and efficient markets' but are less useful when the markets are less liquid. One of the key reasons for the fall was the lack of liquidity caused by banks securing themselves, due to the financial crisis, by asking Lehman to pay off their debts. In addition, even though Lehman had a huge asset base, they lacked assets which could quickly be sold for cash (Brunnermeier, 2009). Apart from the ongoing financial crisis, another aspect that increased the speed of the collapse was the unrealised gains and losses brought about by the usage of fair value accounting (Magnan, 2009). For example, Hughes (2008) mentions that Lehman Brothers ' showed a $400m gain from fair-valuing its own liabilities'. As no other firm wished to buy Lehman, in its state at the time, they declared bankruptcy on the 15th of September 2008 and this was quoted as the largest bankruptcy in the history of the United States (Mamudi, 2008). Therefore, fair value accounting ' without adequate additional disclosure is neither fair nor a good reflection of the value that is at risk' (Magnan, 2009).

To summarise, whilst relevance and reliability are the primary qualities of the usefulness of a financial report, there is a constant debate on the trade-off between these qualities when fair value measurement is adopted. Fair value is known to be relevant as it uses the current market price, however, it sacrifices its reliability as level 2 and level 3 inputs are used. The value of relevance and reliability is equally important because relevant information that has no reliability would mean nothing to the investors (Sing and Meng, 2005). In contrast, Hitz (2007) notes that fair value would be reliable if there

was an actively traded market but the problem arises when there is not. He also remarks that usage of historical cost is falling whereas fair value accounting is on the rise. The reason for this is because fair value provides ‘ more timely and comparable information than amounts that would be reported under other alternative accounting approaches’ (Laux and Leuz, 2009). Furthermore, they add to this by saying that fair value accounting recognises losses earlier than other methods of accounting and this makes it much more difficult to hide problems in the corporation which, if left to grow, would ‘ make crises more severe’. However, we have seen that even through the use of fair value accounting, as in the case of Lehman Brothers, fair value accounting was a significant player behind the crisis of 2008. Wallison (2008) argues that fair value causes ‘ instability among financial institutions’, although the title of the journal suggests that he would be taking a biased stance towards the topic. Moreover, the usage of fair value accounting causes volatility due to constantly changing prices. This concerned banks during the financial crisis due to the enormous write-downs caused by falling asset prices. However, Enria et al. (2004) argue that volatility provides information to investors regarding the risks of their investment. We believe that solely utilising fair value has pitfalls and therefore companies should adopt an integration between historical cost and fair value to eliminate the weaknesses of each. Nonetheless, we conclude that investors still prefer fair value accounting despite the disadvantages and the trade-off because it represents the true economic condition of assets and liabilities.

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LEARNING LOG SUMMARY

(maximum 1 page using Aerial 12-point with at least 1cm margins)

Suggested content:

What did you learn from the assignment both technically and in terms of working together as a group?

- We learnt about what caused the global financial crisis to occur and the impact it had on various financial institutions
- We gained a deeper understanding on the faults in fair value accounting which also shows why historical cost was so prevalent
- We learnt how to allocate work between the members of the group as well as set realistic deadlines

What strategy as a group did you follow in tackling the assignment task?

- Making sure everyone was involved in writing each paragraph so that we received various different viewpoints
- Having frequent meetings and discussions in order to compare our research and decide on which points we should include within our paragraphs

What problems did you face and how did you overcome them?

- Understanding what was required of the question. We overcame this ask question to the lecturer and finding out, through research, about other topics that could be included in each paragraph

What went well?

- Coordination was good since we kept in touch with each other frequently
- Everyone kept to their deadlines and provided what was required of them when needed

What, in retrospect, would you have done differently, why and how?

- In the beginning we took time to assign research topics and research took a while as we were all new to it. However, later on we were able to increase the pace as we became more proficient. If, however, we had been able to start off at this pace, the work would have been more evenly distributed over the weeks rather than being skewed towards the deadline

Where did you locate most of your sources?

- Google
- University of Bath library
- Google Scholar

LOG OF GROUP MEETINGS

(complete a maximum of 1 page for each meeting)

Meeting 1

1. D at e of M 23 Feb 2017 (Thursday)

eeting	
Attendees	Ben Maitland Kylie Siow Gavriella Kafkalia Sidharth Ranjith
Name of Absentees	–
Agenda and tasks completed	2. Decide on days of meeting every week (Tentatively Tuesday

	1-2pm & Friday 12. 30-2pm) 3. Talked about the structure of the essay
Agreed items	Structure of Essay 4. Introduction 5. Pros and Cons of FV – 3 rd of March 6. How it's carried out – 10 th March 7. Example of FV during

	Financial Crisis – 10 th March 8. Conclusion
Tasks to be completed by next meeting	9. Find points for pros and cons of fair value
Date of next meeting	10. 28 Feb 2017 (Tuesday)

Meeting	2
Date of Meeting	28 Feb 2017 (Tuesday)
Attendees	Ben Maitland Kylie Siow Gavriella

	Kafkalia Sidharth Ranjith
Name of Absentees	–
Agenda, items agreed on and tasks completed	• Allocation of points for the first paragraph – pros and cons of fair value accounting to investors

Tasks to be completed by next meeting	• Full paragraph of pros and cons of fair value
Date of next meeting	• 3 March 2017 (Friday)

Meeting 3

Date of Meeting	3 March 2017 (Friday)
Attendees	Ben Maitland Kylie Siow Gavriella Kafkalia Sidharth Ranjith
Name of Absentees	–
Agenda	• Compile

	d the first paragraph • Talk about the next 2 points
and tasks completed	• Global financial crisis • How fair value is carried out
	• Allocate points to each person
Tasks to be completed by next	• Find points for the financial crisis

meeting	and how fair value is carried out
Date of next meeting	• 7 March 2017 (Tuesday)

Meeting	4
Date of Meeting	7 March 2017 (Tuesday)
Attendees	Ben Maitland Kylie Siow Gavriella Kafkalia Sidharth Ranjith
Name of Absentees	–
Agenda	• Choose

and tasks completed	which points to write about and discuss how to evaluate it.
Tasks to be completed by next meeting	• Finish the paragraphs – how FV is carried out and the example during financial crisis

Date of next meeting	• 10 March 2017 (Friday)

Meeting 5

Date of Meeting	9 March 2017 (Thursday)
Attendees	Ben Maitland Kylie Siow Gavriella Kafkalia Sidharth Ranjith
Name of Absentees	–
Agenda and tasks completed	• Completed all body paragraphs
Tasks to	• Introducti

be completed by next meeting	on and Conclusion
Date of next meeting	• 14 March 2017 (Tuesday)

Meeting 6

Date of Meeting	15 March 2017 (Wednesday)
Attendees	Kylie Siow Gavriella Kafkalia Sidharth Ranjith
Name of Absentees	Ben Maitland (However did send his share of the work by

	e-mail)
Agenda and tasks completed	• Completed introduction and draft for conclusion
Tasks to be completed by next meeting	• Complete full paragraph for conclusion and make some changes for body paragraphs
Date of next meeting	• 16 March 2017 (Thursda

	y)
Meeting	7
Date of Meeting	16 March 2017 (Thursday)
Attendees	Kylie Siow Gavriella Kafkalia Sidharth Ranjith
Name of Absentees	Ben Maitland (However did send his share of the work by e-mail)
Agenda and tasks completed	• Worked on conclusion
Date of next meeting	• 18 March 2017 (Saturda

	y)
Meeting	8
Date of Meeting	18 March 2017 (Saturday)
Attendees	Ben Maitland Kylie Siow Gavriella Kafkalia Sidharth Ranjith
Name of Absentees	–
Agenda and tasks completed	• Made some changes to body paragraphs • Finalised the whole

essay